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Use of Trusts in Farm Estate Planning

The purpose of the Ag-Succession series of factsheets is to provide an objective overview of the issues and options related to succession planning. This information should not be a substitute for using a lawyer, accountant or financial planner to help you make a thorough assessment of your specific operation and situation.

What is a Trust?

A trust is a relationship. It is not a separate person or entity like a corporation. It is a relationship between parties with interconnected rights and obligations. A trust operates through its trustees. A trust does not own property; the trustees own the property. Usually, a trust document defines the terms of the trust, but legislation and the common law also have an impact.

A trust relationship arises when one person (the settlor) transfers property to another person (the trustee) to be held for the benefit of other persons (the beneficiaries). It can also occur when one person declares himself to be a trustee of property for another. Another example is when a court declares that someone holds property on trust for another.

In a trust there is a separation between the holders of legal title and beneficial title to the trust property. The trustee is the legal owner of the property (for example, the registered owner of land at Land Titles or the owner of a bank account). The beneficiary is not the legal owner, but is eventually entitled to the property in accordance with the terms of the trust. The beneficiary is therefore the "beneficial owner."

For example:

A grandmother wants to give a quarter section of land to her 17-year-old granddaughter upon her death, but does not want her to own the property until she is 25 years old. The grandmother includes a clause in her will providing that the quarter section be transferred to the child's father to be held on trust until the granddaughter turns 25. She provides that the father may rent the land because he requires it in his farming operation, but that all the income must be used for the granddaughter's education. When the granddaughter attains the age of 25, the land is to be transferred to her, along with any unpaid income.

In this example, the grandmother is the settlor of the trust, the father is the trustee and the granddaughter is the beneficiary. The father, as trustee, becomes the registered owner of the land, but holds it on trust for his daughter. This gives the trustee legal control over the land, including the power to rent it and grant surface leases. The granddaughter can enforce the trust by requiring the trustee to provide the income for her education and to transfer the property to her, but only when she attains the age of 25 years.

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There are a number of tax considerations in establishing this trust. There is no farm rollover with this type of trust because it might not vest indefeasibly in the name of the granddaughter within 36 months of the date of her grandmother's death. However, if the land qualifies for the $500,000 farm capital gains exemption, this should not be a concern. Tax advice should be obtained before establishing a trust, especially with farm assets.

As the legal holder of the property, the trustee owes a fiduciary duty to the beneficiaries and has the duty to manage the trust property in accordance with the terms of the trust document. In contrast, the beneficiaries enjoy the benefits of the trust property. If the trustee does not follow the terms of the trust, the beneficiaries can sue the trustee and the court can order the trustee to carry out the terms of the trust, replace the trustee or award damages against the trustee for breach of trust. It is this separation of legal and beneficial ownership that establishes a trust relationship and makes it an useful estate planning instrument.

Uses of Trusts

Trusts have been used in a wide variety of situations, for a wide variety of reasons. Common tax reasons for using a trust include:

- income splitting
- reducing capital gains on death
- utilization of multiple testamentary trusts to access graduated tax rates
- accessing benefits of the spousal rollover provisions in the *Income Tax Act*

In many cases, there are also non-tax related reasons for using a trust. These often, include:

Creditor Proofing

The trustees own the legal title to the property and therefore control it, while the benefits derived from it are passed to the beneficiaries in accordance with the terms of the trust. This attribute is useful if the desire is to safeguard assets from claims by creditors. The property does not belong to the trustee and cannot be claimed by the trustee's creditors. If the trustee goes bankrupt, the trustee can be replaced and the trust continues. The property does not belong to the beneficiary until it vests absolutely in the beneficiary's name and the beneficiary can demand an immediate transfer of the property.

For example, if farm property is held in a testamentary trust for the life of the farming child and then to the farming grandchild, it never vests absolutely in the name of the farming child. Creditors of the farming child cannot seize the property because the child does not own it and never will own it. The creditors of the grandchild cannot seize the property until the death of the farming child as only then does it become the property of the grandchild. If the grandchild predeceases the child, the trust might provide that the land pass to another child. Therefore, the grandchild never becomes the owner of the land unless he/she is alive at the death of the farming child.

Note: this kind of trust might not qualify for the farm rollover if the land does not vest indefeasibly in the name of the grandchild within 36 months of the death of the settlor.

Protection from Matrimonial Property Claims

By using a discretionary trust, the beneficiaries have no vested interest in the trust property until the trust is wound up. Until that time, the trust property is protected from any matrimonial property claims that may be brought against a beneficiary (depending on the terms of the trust).

Confidentiality

By using a trust, the name of a beneficiary need not be disclosed as the trustee transacts business in the name of the trustees or in the name of the trust.

Flexibility

With a discretionary trust, the decision as to what beneficiary should inherit what asset, and in which proportion, can be postponed to a future date. The trustee can be given the discretion to determine which beneficiary receives the farm property.

For example, for young farm couples, the will can provide that the farmland and non-farm assets are held on trust for the benefit of all of the children, until the youngest child attains the age of 21 years. The trustee is then given the discretion to decide which child or children receives the farmland, and what assets are passed to the non-farming children.

A flexible trust in a will can provide lots of powers to assist the trustee in making the decision at that time including a power to mortgage the land for the benefit of the non-farming children before transferring the land to the farming child.

Note: This kind of trust would not qualify for the farm rollover if the land does not vest indefeasibly in the names of the children within 36 months of the death of the parents.

Protection for a Handicapped or Incapable Beneficiary

It may be desirable to separate legal ownership from beneficial ownership where the beneficiary is incapable of managing property due to mental incapacity. Thus, a parcel of farmland can be held on trust for a handicapped child for life, with income paid to the child annually. On the death of the child, the land can be transferred to the other children or the farming child. Property can also be held on trust for an elderly person in a nursing home for his or her maintenance and support. Upon death, the property is transferred to the other beneficiaries.

Protection for Minors

A trust is especially useful for minors. Most parents think that age 18 is too young for a child to receive a share of an estate and a trust can delay transfer to the beneficiary to say age 25, 30 or 55. If the child dies before the age specified, the trust can specify that it be transferred to other beneficiaries.

Taxation of Trusts

For tax purposes, a trust is considered to be a separate taxpayer. Therefore, the trustees are required to file a tax return for the trust (a T3 return) every year and the trust pays tax as if it were a separate person.

In most cases, when a person (the settlor) transfers property to a trust, the settlor is deemed to have sold it. If the property has increased in value since the settlor acquired the property, the settlor is subject to tax on the capital gain, unless it qualifies for the $500,000 enhanced capital gains exemption. This tax rule can be used to advantage to 'bump up' the cost base of the property by utilizing the farm capital gains exemption. If the land is transferred directly to the farming child, the land automatically rolls over to the child at the parent's cost base. An *inter vivos* trust can therefore be a useful tax-planning tool.

A testamentary trust is a trust that is created upon death. The *Income Tax Act* defines a testamentary trust as arising "on and as a consequence of the death of an individual." A testamentary trust can be found in a will or other testamentary disposition (such as an insurance trust), or as a result of a person dieing without a will (intestacy). A testamentary trust can also be imposed by court order. This happens when a dependent applies for a greater share of an estate under the *Dependants Relief Act*.

An *inter vivos* trust is a trust that is created during the lifetime of the person (the settlor) who creates the trust. Under the *Income Tax Act*, an *inter vivos* trust is defined as "a trust other than a testamentary trust."

The taxation of trusts varies depending on the type of trust created. Income retained in a testamentary trust is taxed at the graduated rates of tax like a person (except that there is no basic personal exemption). Income retained in an *inter vivos* trust is taxed at the highest marginal tax rate, 39 per cent in Alberta (2003 tax rates).

One of the benefits of qualifying as a personal trust is the ability to transfer the property of the trust on a tax-deferred basis to a beneficiary. In most cases, the property is distributed to the beneficiaries without tax being paid at the time of distribution.

Note: There are some exceptions to the roll out of property from a trust to a capital beneficiary. Also, a trust is deemed to have sold all of its assets every 21 years, thus giving rise to tax on any capital gains unless the trust is wound up beforehand. This does not apply to spousal trusts.

There are many other types of trusts defined under the *Income Tax Act* (e.g., spousal trusts, alter ego trusts, bare trusts, joint spousal trusts, etc.). Each has its own tax rules. Legal and tax advice is recommended when creating a trust to ensure that the appropriate tax consequences are planned for.

A Practical Example – the Spousal Trust

Spousal trusts provide an example of the usefulness of trusts. Spousal trusts were traditionally used to provide for the management of an estate for the benefit of a surviving spouse who might not have the skills to manage investments. Today, a surviving spouse has access to a vast array of resources to assist in the investment of assets. Therefore, an independent trustee may not always be appropriate. The modern trend is to

have faith and trust in the surviving spouse that an absolute gift of the entire estate is most appropriate. However, there are a number of scenarios where the use of a spousal trust is desirable:

The Second Marriage

If the entire estate is left absolutely to the surviving spouse, there is no guarantee that on the death of the surviving spouse, the assets will be left to the children of the first marriage. The spousal trust allows the assets to be held for the life of the second spouse with all of the income paid to the spouse for life. There is usually a power given to the trustees to encroach on the capital in the event the income is not sufficient or in case unusual circumstances arise. On the death of the spouse, the amount remaining on trust can be transferred to the children of the first marriage. This is particularly useful in family farming scenarios to ensure that the farm passes to the farming child from the first marriage.

Remarriage

What if the spouse remarries and leaves the entire estate to the new spouse? The farming child has no recourse other than to commence an action in unjust enrichment for the labours spent on the farm. The spousal trust ensures farm property passes to the farming child upon the death of the surviving spouse.

Spendthrift Spouse

If the husband is a compulsive gambler, the spousal trust ensures that the land remains on trust for the use of the surviving spouse for life, with a gift over to the farming child. The trustee is the legal owner and only the trustee can sell or mortgage the land.

Trust

If the spouse does not trust the surviving spouse to leave the farm to the farming child, a spousal trust ensures that the land passes to the farming child upon the death of the surviving spouse. The trust could provide that the farming child be allowed to rent the land at fair market rent for the life of the spouse and that the land then be transferred to the child on the death of the spouse.

Incapable Spouse

If the surviving spouse is incapacitated due to a stroke or Alzheimer's disease, the farm assets can be rolled over to a spousal trust for life with a gift over to the farming child on the death of the spouse.

Income Splitting

On the death of one spouse, if all of the assets pass to the surviving spouse, that spouse pays tax on all of the income earned on the farming assets. If the surviving spouse is already in a higher tax bracket, or will be taxed at a higher rate as a result of the inheritance, the income earned on the inheritance will be taxed at the surviving spouse's higher tax rates. In this circumstance, a spousal trust in the will could save substantial tax annually.

The spouse will be entitled to all of the income during life with an ability to encroach on the capital when necessary. Under the *Income Tax Act*, the trust can elect to have the income taxed in the hands of the spouse, or alternatively, paid by the trust at the graduated rates of tax (assuming a testamentary spousal trust). The spouse receives the income, but it is taxed in the trust at rates lower than the spouse would pay. Depending on the type of income, the size of the estate and the applicable tax rates, a significant amount of tax can be saved each year.

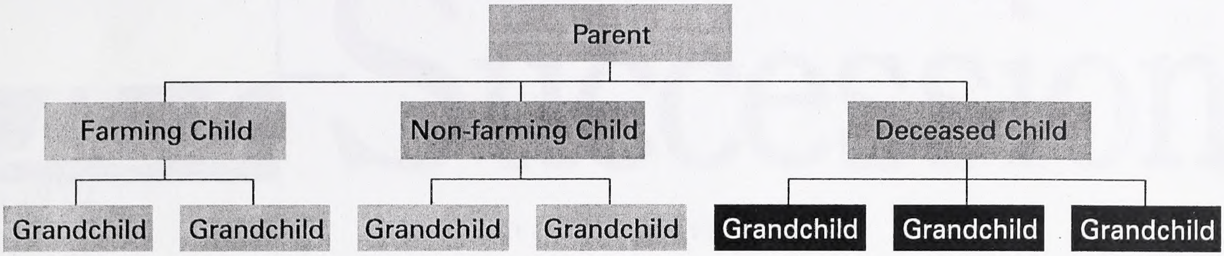
Note: A court can change a trust if the surviving spouse applies for a greater share of the estate under the *Dependants Relief Act*.

A Practical Example – the Insurance Trust

Life insurance can be a very useful part of a farm estate plan. For example, if the parents wish to pass the farm to the farming child, there may not be sufficient assets available for the non-farming children. Placing insurance on the lives of the parents can be used to more or less equalize the division of the estate.

When the parents die, the insurance benefits are used to pay the non-farming children their share of the estate. The farm passes to the farming child and the non-farming children receive a fair share of the estate, including insurance. The difficulty with this solution lies in the nature of designating beneficiaries of life insurance.

- Under the *Insurance Act*, only the surviving beneficiaries are entitled to the insurance proceeds. If two of the children are named as beneficiaries and one predeceases the parents, the surviving child receives all the insurance. The parents would probably want the deceased child's share to pass to his or her children (grandchildren). This should be specified in the designation.



- If a minor is designated as a beneficiary, the funds are paid to the Public Trustee and held until beneficiary attains the age of 18 years. The alternative is to establish a trust of the insurance for the minor beneficiaries so that they receive the money at a more mature age. The parents can also choose a trustee of the funds.

What if the farming child predeceases the parents? Or what if there are a number of children who might wish to take over the farm? A life insurance trust could be designed to allow the insurance to be held by a trustee until it is decided who will take over the farm. Then the insurance can be divided in proportion to the farming assets for a fair distribution of the entire estate.

A person can designate a beneficiary with the insurance company or in a will. The most recent designation takes effect. It is often useful to include the insurance designation in the will because it can be co-ordinated with other provisions of the will and the insurance does not form part of the estate, if properly drafted.

Conclusion

Trusts are a very useful tool in farm estate planning. The property is held by a trustee for the use of a beneficiary for a period of time and later transferred to the beneficiary or to a different person when certain conditions are satisfied. The person establishing the trust can determine the conditions when the property is to be transferred such as attaining a certain age, or farming the land for a period of time.

Glossary

Settlor: The person who establishes the trust by transferring property to a trustee and directing the terms of the trust. The trust can be established during life (such as a family trust) or on death (such as through a will).

Trustee: The person who owns the legal title to property to be held for the benefit of the beneficiaries.

Beneficiary: The person who enjoys the trust property, but only in accordance the the terms of the trust.

Testamentary Trust: A trust established as a consequence of the death of a person, such as through a will or an insurance trust.

***Inter vivos* Trust:** A trust established during a person's lifetime.

Vested Indefeasibly: The beneficiary is absolutely entitled to a transfer of the trust property. There are no conditions that provide that the property be transferred to another person if the beneficiary does not satisfy the conditions of the trust (such as the beneficiary dieing before age 21).

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